RECEIVED

JAN 28 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

MILLER & HOLBROOKE

1225 NINETEENTH STREET, N. W.

WASHINGTON, D. C. 20036

TELEPHONE (202) 785-0600
FACSIMILE (202) 785-1234

TERESA D. BAER
FREDERICK E. ELLROD III
LISA S. GELB
LARRINE S. HOLBROOKE
ELDRED INGRAHAM**
TILLMAN L. LAY
NICHOLAS P. MILLER
JOSEPH VAN EATON

WILLIAM R. MALONE
OF COUNSEL

BETTY ANN KANE*
FEDERAL RELATIONS ADVISOR

*NOT ADMITTED TO THE BAR
**ADMITTED IN PENNSYLVANIA ONLY

January 28, 1993

Ms. Donna R. Searcy
Secretary
Room 222
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Errata to Comments Filed in MM Docket 92-266

Dear Ms. Searcy:

It has come to our attention that, in the course of reproduction, pages may have been unintentionally omitted from certain copies of the comments we filed Wednesday, January 27 on behalf of Austin, Texas, et al. in the above docket. Therefore, we are re-submitting an original and four copies of the comments in their entirety. We would appreciate it if you would substitute these for the previously-filed copies.

Please give me a call if you have any questions. I appreciate your assistance.

Very truly yours,

MILLER & HOLBROOKE

Nicholas Miller

By Nicholas P. Miller

NPM/tme
Enclosure
(0365)fcc.let

No. of Copies rec'd 0+4
List A B C D E

RECEIVED

JAN 28 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation	MM Docket No. 92-266

COMMENTS OF AUSTIN, TEXAS; DAYTON, OHIO; DUBUQUE, IOWA; GILLETTE, WYOMING; MONTGOMERY COUNTY, MARYLAND; ST. LOUIS, MISSOURI; AND WADSWORTH, OHIO

A P P E N D I C E S

Nicholas P. Miller, Esquire
Joseph Van Eaton, Esquire
Lisa S. Gelb, Esquire
MILLER & HOLBROOKE
1225 Nineteenth Street, N.W.
Suite 400
Washington, D.C. 20036

January 27, 1993

RECEIVED

JAN 28 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

REPORT TO THE FEDERAL COMMUNICATIONS COMMISSION IN RESPONSE TO NOTICE OF PROPOSED RULEMAKING TO IMPLEMENT RATE REGULATION SECTIONS OF THE CABLE TELEVISION CONSUMER PROTECTION AND COMPETITION ACT OF 1992

(FCC 92-544; MM Docket 92-266)

January 27, 1993

ANALYSIS OF CABLE TELEVISION RATE MODELS AND PROPOSAL FOR DEVELOPMENT OF COST-BASED INDUSTRY NORMS

Submitted by:

Mr. Jay C. Smith
Public Knowledge, Inc.
Portland, Oregon

Mr. Michael Katz
KFA Services
Edmonds, Washington

About the Authors

Mr. Jay C. Smith is president of Public Knowledge, Inc., a professional firm in Portland, Oregon providing financial analysis and operations consulting services. Over the past ten years, Mr. Smith has assisted over fifty local franchise authorities with financial aspects of cable television regulation, including franchising, renewal, rate regulation, and ownership transfer proceedings. He has frequently served as an expert witness on issues relating to the economics of local cable system operations. Mr. Smith has also consulted to electric and other utility organizations on rate setting and cost allocation matters. He holds an undergraduate degree in economics and business administration and two interdisciplinary masters degrees from the University of Illinois. He has been a professional management consultant for 17 years, and is a Certified Management Consultant.

Mr. Michael Katz is the principal of KFA Services, an Edmonds, Washington firm providing financial, accounting, and economic analysis services to private and public sector clients. He frequently assists franchising authorities with cable television financial issues, and has served as an expert witness in cases involving cable system or other business economic matters. Mr. Katz has also developed cost finding and rate setting methods in other industries, including nursing homes, municipal utilities, the aerospace industry, and others. He holds an undergraduate degree in mathematics from the Massachusetts Institute of Technology (MIT), a masters degree in mathematics from Columbia University, and a masters degree in business management from MIT. Mr. Katz has been a professional management consultant for 19 years and is a Certified Management Consultant.

During the course of their work involving cable television, Mr. Katz and Mr. Smith have reviewed financial statements and financial projections for numerous local systems. They have also developed and applied cost analysis and revenue requirements models similar to the approach suggested in these comments.

Summary of Report

This paper comments on each of the possible rate regulation approaches identified by the Federal Communications Commission (Commission) to implement sections of the Cable Television Consumer Protection Act of 1992 (Act). It suggests that the same approach should be applied to both basic tier services and "cable programming services" (expanded basic tier).

Our fundamental position is that a cost-based approach is required if the monopoly component of rates is to be reduced. The approach can be simplified by choosing certain significant norms; that is, benchmark costs may be applied.

The summary advantages and disadvantages of the regulatory methods identified by the Commission are as follows:

- Using a benchmark of the rates charged by systems with effective competition could potentially produce reasonable rates, but there is unlikely to be a sufficient sample of such systems. Cost information, as well as rate information, will also be needed. Nevertheless, we believe that rate data for these systems can be useful as evidence of the size of the monopoly component in current rates, particularly if the results are checked by examining municipally owned systems.

- Applying 1986 rates, with an adjustment factor, could lead to lower rates, but this approach presents several problems. The difficulties include the facts that the base 1986 rates may not have been reasonable, and problems arise in doing comparisons when there has been widespread re-tiering since 1986. Reconstructing the history of particular systems since 1986 could be difficult. Simpler averaging approaches may be insensitive to certain local cost factors that are enumerated in the Act as criteria for consideration.

- As the Commission recognizes, a benchmark based on the current average rates would not achieve the most important Congressional objective, achieving rates that are no higher than if there were effective competition. There would be several issues regarding possible comparability distortions if such an approach were implemented.

- The Commission suggests a cost-of-service benchmark approach, which is similar to the approach we recommend. Our recommended approach varies slightly from that described by the Commission in that we would allow the possibility of combining certain local specific information along with national norms to achieve the benchmark result for each community.

- Price caps could be a relatively uncomplicated approach to adjust rates once they have been reasonably set, but cannot be used to establish the initial regulated rates. The cost-of-service benchmark model we propose could be an effective way for the Commission to determine the annual price cap index, fairly reflecting the actual cost factors in the industry.

- Applying the direct cost of signals plus a nominal contribution to joint and common costs could produce low rates for the lowest basic service tier, and potentially could be administratively simple. In fact, in many systems there may be no truly direct programming or other direct costs on the lowest tier. However, possible undesirable re-tiering incentives could result from this approach.

- A system-specific utility cost-of-service approach could produce fair rate results, but could be difficult to administer if it were the primary method for all franchise areas. We believe that it should be preserved for those local franchise authorities who wish to apply it. If it is to be used on appeals to the Commission, however, we believe that franchising authorities as well as cable operators should be able to bring them. There are also several cost-of-service issues on which we believe the Commission should take a position, whether a system-specific utility approach or a cost-of-service benchmark is applied; these include:

  - Possible distortions resulting from related-party transactions should be corrected in the rate-setting process.

  - Intangible franchise value should not be allowed in the rate base, because to do so would guarantee returns above competitive levels, contradicting the intent of Congress.

  - Write-ups of tangible assets resulting from system sales should be disallowed in the rate base.

  - Capital and operating expenditures should be allowed only if prudent.

In an appendix to our report, we propose a cost-of-service benchmark model to assist franchising authorities and the Commission to regulate cable television rates, consistent with the requirements of the Act. The model can be applied using primarily certain national normative data on cable television system costs, or can be combined with inputs specific to a local franchise area. It calculates a rate ceiling for both basic and expanded basic service tiers. It addresses each of the factors that Congress and the Commission specified for consideration. We believe that the model has the following benefits:

- Assures that basic service and expanded basic rates are reasonable, protecting subscribers of any system not subject to effective competition from paying rates higher than those that would be charged if the system were subject to effective competition.

- Applies consistent procedures to basic and expanded basic tiers.
- Requires only information that is readily obtainable.
- Is based on a simple spreadsheet or tables that may be distributed to local franchising authorities to ease administrative burdens for both local authorities and the Commission.
- Provides appropriate incentives for cost control by applying normative costs.
- Reflects the key relevant factors.
- May be used as the method to determine annual price cap changes.

An explanation of the suggested model is included in the appendix.

A second appendix reviews the evidence of the monopoly status of local cable television systems. It concludes that there is ample reason to believe that basic and expanded basic rates should be significantly lower than they are currently in most systems if the "competitive rates" objective of the Act is to be achieved. For example, we believe that the $10 to $11 rate certain operators are now announcing for a stripped down basic tier of service will be at least twice as high in most systems as it should be if it were cost based.

REPORT TO THE FEDERAL COMMUNICATIONS COMMISSION IN RESPONSE TO NOTICE OF PROPOSED RULEMAKING TO IMPLEMENT RATE REGULATION SECTIONS OF THE CABLE TELEVISION CONSUMER PROTECTION ACT OF 1992

1. Introduction

The Federal Communications Commission (Commission) seeks comments on rate regulation approaches to implement sections of the Cable Television Consumer Protection Act of 1992 (Act).[1] The Notice of Proposed Rulemaking (NPRM) identifies objectives of the Act and factors cited in the Act that the proposed rate regulation method should address.[2] The Commission proposes two broad approaches, benchmarking and cost-based, and expresses a preference for a benchmarking approach.[3] The Act requires that the regulatory method should assure that basic service tier rates are reasonable, protecting subscribers of any cable system not subject to effective competition from paying rates higher than those that would be charged if the system were subject to effective competition.[4] The method should also seek to limit the administrative burden on subscribers, cable operators, franchising authorities, and the Commission.[5]

To achieve these objectives for the basic service tier, the Act directs the Commission to consider certain factors:[6]

- The rates for cable systems that are subject to effective competition
- The direct costs of obtaining, transmitting, and providing basic tier programming
- Only a reasonable and properly allocable share of joint and common costs
- Revenue from advertising or other consideration in connection with the basic tier

---

[1] FCC 92-544. Notice of Proposed Rulemaking (NPRM) adopted December 10, 1992; released December 24, 1992. MM Docket 92-266.

[2] NPRM para. 30 for the basic service tier; para. 90 for "cable programming services."

[3] NPRM para. 33 for the basic service tier; para. 92 for "cable programming services."

[4] Communications Act, Section 623 (b) (1), 47 U.S.C. Section 543 (b) (1). NPRM para. 30.

[5] Communications Act, Section 623 (b) (2) (A) and (B), 47 U.S.C. Section 543 (b) (2) (A) and (B). NPRM para. 30.

[6] NPRM para. 30.

- The reasonable and properly allocable portion of taxes and fees imposed by any state or local authority
- The cost of satisfying franchise requirements to support public, educational, and access (PEG) channels
- A reasonable profit, consistent with the goal of protecting subscribers in any cable system not subject to effective competition from paying more for the basic tier than subscribers would pay if the system were subject to effective competition.

The factors to be considered for "cable programming services" (expanded basic tiers) rates are similar.[7]

- Rates for similarly situated systems taking into account similarities in costs and other relevant factors
- Rates of systems subject to effective competition
- The history of rates for the system including their relationship to changes in general consumer prices
- The system's rates as a whole for all services other than programming provided on a per channel or per program basis
- Capital and operating costs of the system
- Revenue from advertising or other considerations associated with the services.

The objectives of the Act and the factors it specifies to consider are sufficiently similar for the basic service tier and "cable programming services" (expanded basic tier), that we believe the same method for determining reasonable rates should be applied to each category.[8] We therefore agree with the Commission's tentative conclusion that the advantages and disadvantages of the various alternatives the Commission discusses in the NPRM for the basic tier are equally applicable to the expanded basic tier (or tiers).[9]

Consequently, we present an integrated set of comments on the methods the Commission has specified, covering both basic and expanded basic service tiers.[10] These methods include:

---

[7] NPRM para. 90.

[8] We will use the term "expanded basic" tier to mean service tiers (other than per channel or per program pay services) for which the subscriber must pay a fee higher than that paid for the lowest tier.

[9] NPRM para. 92.

[10] Methods discussed in NPRM paras. 34 through 61. The Commission believes that each of these methods, with the exception of "direct cost of signals/nominal contribution to joint and

Benchmark alternatives

- Rates charged by systems facing effective competition
- Past regulated rates
- Average rates of cable systems
- Cost-of-service benchmark
- Price caps

Individual system cost-based alternatives

- Direct cost of signals plus nominal contribution to joint and common costs
- Cost of service

2. Rates Charged by Systems Facing Effective Competition[11]

Presuming there were a sufficiently large number of such systems and that the data were effectively collected and applied, this method would appear to meet two of the key objectives of the Act: it would help assure that subscribers where there is no effective competition pay rates no higher than where there is, and the method would not be unduly administratively burdensome. Therefore, we encourage the Commission to collect data from systems in communities where there is effective competition to help provide a basis for regulating rates in areas where there is not.

We suggest that the Commission collect actual cost information from these and other systems, as well as rate information. By this we mean cost information derived from system accounting records, not just information regarding factors that influence cost (such as plant mileage, the number of subscribers, etc.). This will enable the Commission to assess the relationship between costs, rates, and the driving factors for these systems to better understand how the information may be fairly applied as a benchmark for other communities. The cost information for these systems could be applied as an important part of the data base to develop cost norms for another approach that we recommend. For instance, presumably there are incentives for operators to both be efficient and provide good service in communities where there is effective competition, so the cost information would be less likely to be either overstated (including imprudent expenditures) or understated (reflecting inferior service). Another reason for examining the cost information is that the cost data for these systems are likely to be more stable than the rate data, as rates may change frequently in competitive marketing strategies.

common costs," could be applicable to expanded basic as well as to low basic tiers (NPRM para. 92).

[11] NPRM paras. 41 through 43.

The principal disadvantage of an approach based solely on competitive system rates is that there is unlikely to be a sufficiently large and diverse group of such systems, at least for the next several years, to make it feasible for this data base alone to be reasonably applied to cover all systems. Competition between cable systems is rare and tends to be unstable, and frequently systems that once competed become merged or one operator ceases business. Price competition may not occur if one operator is in the process of selling to the other, or if an operator serves a large, non-competitive area and the competitive area is limited. Indeed, the rarity of effective competition appears to be one of the key reasons for the Act, and the instability of the competition is itself evidence of the monopoly characteristics of the industry.[12]

One way to increase the amount of data for "effective competition" areas is to include areas if the franchising authority itself "offers video programming to at least 50 percent of the households in that franchise area," regardless of whether actual competition exists.[13] There appear to be at least 60 or more jurisdictions where this is the case.[14] However, we caution that a municipal system could price based on costs and a return to recover its investments, or by setting rates so that they are comparable to rates charged by private systems.[15] We suggest that the Commission include these jurisdictions in its data collection efforts for effective competition areas. The Commission should collect and analyze cost data as well as rate data for these jurisdictions. An understanding of the cost information for municipally owned systems will help the Commission to determine what adjustments, if any, should be made for operating cost, tax, and cost of capital factors to make the municipal data comparable to information for privately owned systems.

In addition, we believe that an average rate per channel approach would lead to unduly high rates for systems with high channel capacity on the basic tiers, because there is unlikely to be a large group of high channel capacity competitive systems in the near term. There are economies of scope in cable operations, so that total costs generally do not increase in proportion to increases in channel capacity. Extrapolating rates per channel from smaller systems to a larger system would not capture these economies. That is, the cost per channel typically declines as channel capacity increases.

---

[12] This issue is discussed further in Appendix B.

[13] NPRM para. 7. Communications Act, Section 623 (1) (1) (B), (C); 47 U.S.C. Section 543 (1) (1) (B), (C).

[14] "Municipally Owned Cable Television Systems," Public Power, January-February, 1993, pp. 156 - 159. There are also many co-operative or non-profit systems that could add further to the data base.

[15] A few of these systems are in fact in competition with privately owned systems.

The Commission has already initiated a survey to obtain rate data for effective competition areas, among others. In spite of our caveats and concerns, we suggest that the Commission analyze the "effective competition" sample results as preliminary evidence of the size of the monopoly component in cable rates where there is no competition. (See Appendix B). Over the long term, the Commission should collect cost data, not just rate information, from a broad cross section of cable systems, including those involved in competition.

3. Past Regulated Rates[16]

The Commission considers developing a benchmark based on rates charged in 1986. This approach would assume that rates in 1986 were reasonable because basic rate regulation of most cable systems was permitted at that time, and various factors would be applied to adjust these rates to the current period. The Commission apparently contemplates a system-by-system approach, where certain system-specific data (for example, rebuild or construction costs) would be applied, although it also seeks comment on whether average rates might be used as the benchmark.

Although this approach would likely lead to lower rates than if current average rates are used as the benchmark, we see several problems in attempting to implement it. First, it is not correct to assume that merely because most franchising bodies had the legal authority to regulate basic rates through 1986 that they exercised it. In fact, only a small minority of local jurisdictions assessed the fairness of cable television rates, and thus there is no assurance that overall 1986 rates bore a reasonable relationship to costs at that time. In addition, it may be difficult to extrapolate 1986 rates forward to the present. Many systems, if not most, have re-tiered or otherwise changed their channel line-ups since 1986, so there would be comparability issues. Using a per channel approach could lead to distorted results. Rates on a per channel basis for old, 12-channel systems are often higher than for larger systems. This reflects the fact that there are economies of scope in cable operations, so that total costs do not generally increase in proportion to increases in channels. Further, operators can reduce costs by moving more expensive services off the system, or to higher tiers. For instance, how would one treat a system that offered 20 basic services, including all of the most popular basic programming, on the lowest cost tier in 1986, but today has moved all of the most popular cable programming to a higher tier, even though there still may be 20 channels of broadcast, PEG, educational, and less popular programming on the lowest cost tier?

---

[16] NPRM paras. 44 and 45.

4. Average Rates of Cable Systems[17]

Although potentially not administratively burdensome, this alternative cannot result in establishment of reasonable rates. The Commission rightly concludes that the use of current average data, unadjusted, "would not reflect competition but merely average performance in the industry; if monopoly profits were reflected in the rates of at least some industry segments, they would be incorporated in the average rate."[18] Thus the use of current average rates would likely violate the intent of Congress, who declared for example, that there is "...undue market power for the cable operator as compared to that of consumers and video programmers."[19]

However, we do encourage the Commission to regularly collect and analyze data on current rates, and to obtain and assess cost data as well so that a systematic consideration of the relationship among costs, rates, and other factors may inform Commission and local franchise authority proceedings on cable rate matters. We caution again that it is not a simple matter to express rates in a manner that is comparable across systems. In addition to the "per channel" and program line-up variation difficulties already noted, there are currently many variations among systems in how installations, additional outlets, and converters or remote controls are priced and either factored in or not factored in to the monthly charges. The treatment of franchise fees and other local cost factors also varies notably across systems. While some of these problems may be mitigated by new Commission rules, they would be inherent in any 1992 or 1993 data that the Commission might attempt to use as a starting point.

5. Cost-of-Service Benchmark[20]

Under this approach the Commission would use certain data to construct the costs of an "ideal" or "typical" cable system or systems. The Commission contemplates a national benchmark or several benchmarks representing groups of identifiable system characteristics.

This approach comes the closest to the one we recommend. One of its advantages is that it would base rates on costs, which we believe is the best approach to help assure that the rates cover reasonable and prudent costs, but do not significantly exceed costs, including a fair return

[17] NPRM paras. 46 and 47.

[18] NPRM para. 47.

[19] Senate Conference Report on the Act, Section 2 (a) (3).

[20] NPRM para. 48.

on investment. The approach that the Commission proposes would also not be unduly burdensome, because there would be a limited number of applicable benchmarks (based on system characteristics), and extensive data would not be required for each individual system.

We propose instead a modified cost-of service benchmark approach that applies certain industry cost norms along with certain straight-forward and readily obtainable system-specific information to generate ceiling rates for each franchise area that seeks to regulate basic service tier rates, or for areas where the Commission must determine whether expanded basic rates are unreasonable. We believe that the proposed approach is very feasible, and we have outlined it in detail in Appendix A.

6. Price Caps[21]

The price cap would not be a method to set initial rates, but to define reasonable rate changes in the future. It would therefore be used in tandem with one or more of the other approaches which would be used to set initial rates. The Commission has cited certain advantages of the price cap approach; for example, it creates incentives for companies to operate efficiently and minimizes the amount of regulatory intervention required to help assure that rates remain reasonable.[22] We agree with the advantages cited with respect to using price caps for future rate changes, but only after a reasonable cost-based benchmark has been established.

The questions posed by the Commission generally have to do with how the price cap should be developed, revised, and administered. Selecting a single index may not be appropriate because there is no existing index that reasonably reflects the production factors applicable for a cable system. Single factor approaches, such as changes in the cost of programming, are also inappropriate because no single factor clearly dominates the cable industry cost structure. Further, certain highly material costs, such as the construction of the plant, do not change once they are sunk. It therefore seems that if the Commission is to apply a reasonable and workable price cap escalator, it will need to construct one. We believe that the cost-of-service benchmark model that we propose in Appendix A provides an appropriate method not only to determine the reasonable starting point for rates, but also to index changes in cable system costs over time, in a manner that fairly represents the key cost factors in the industry.

---

[21] NPRM paras. 49 through 52.

[22] NPRM para. 51.

7. Direct Costs of Signals Plus Nominal Contribution to Joint and Common Costs[23]

This alternative would seemingly meet the objective of achieving basic service rates that are no higher than competitive rates because the Commission apparently intends that this method would cover direct costs, but could recover less than the fully allocated costs of the basic tier.

The Commission raises the possibility that very low basic service rates -- set on the assumption almost no joint and common costs are allocated to basic -- could discourage operators from placing more valuable services on the low basic tier.[24] That is one reason why we believe that, as an initial matter, the same regulatory method and an integrated approach should be applied to basic and expanded basic levels of service, and why the Commission must be especially vigilant in fulfilling its duty under the Act to assure that expanded basic rates do not become unreasonable. Like the "nominal cost" approach, the approach we propose in Appendix A would likely result in basic service rates on the lowest tier that would be significantly below what they are now in many systems. But, unlike the "nominal cost" method, our proposed approach would allocate costs on an equitable basis to the lowest basic tier and upper tiers, thus providing the Commission a mechanism to assess expanded basic rates and overall rates. To the extent required by statute, the "nominal" cost approach could be applied at the local level.

8. Cost of Service[25]

Whether the Commission chooses to apply cost-of-service principles either as part of a primary benchmark model or as a secondary outlet to correct aberrant results (using either our proposed model or a more traditional utility approach), several key issues must be resolved and reflected in the regulations ultimately adopted by the Commission. We comment below on some of the critical issues presented in a pure cost-of-service model including:

- Related party transactions
- Depreciation and rate base
- Intangible assets

---

[23] NPRM paras. 53 through 56.

[24] NPRM para. 55.

[25] NPRM paras. 57 through 61.

- Tangible asset values

- Prudency

Related-party transactions. The Commission should be alert to related-party transaction pricing issues, both in constructing cost norms for a benchmark model and in reviewing system specific cost-of-service information. A particular issue is the practice used by certain multiple system operators (MSOs) for assigning programming costs to local systems. In some cases, we believe, the costs shown in local system statements may include a mark-up added by the parent company, over its cost to acquire the programming from the supplier. This issue is compounded by the fact that the transactions between certain MSOs and certain program suppliers are not arms-length, due to cross ownership. Consequently, we believe that the price the parent company pays should be analyzed to develop cost norms or to evaluate actual programming costs.

We have a similar concern regarding other charges from the parent company, including general and administrative overhead allocations and management fees. In either a benchmark cost model or in reviewing specific system costs, the Commission should assure that any such costs included are reasonable. One test, for example, is whether the cost would be incurred if the local operation were autonomous.

Another such concern is the practice of having advertising revenue flow to an affiliated company, with only some or none of this revenue recorded on the books of the local system. This practice could affect the proper consideration of revenue off-sets to subscriber rates, which Congress directed to be considered in rate regulation.

Depreciation and Rate Base. In our proposed model (Appendix A) we develop a "rate base" based on replacement costs and we assess revenue requirements on a cash basis, before depreciation. We believe that cash flow operating results are more meaningful in the industry than post- depreciation results, and industry analysts typically look at cash flows as one of the key factors to assess the financial health of cable systems. Our model is fair to operators because we include an allowance for replacement or upgrade costs, and the return-on-capital base is valued at replacement cost, not net depreciated value. However, if a cost-based approach is to be applied on a system specific basis (distinct from determining norms), a depreciated rate base approach may be more meaningful. This would be especially true in situations where the plant is old and has not been upgraded.

Intangible assets. To the extent the Commission becomes involved in system-specific cost-of-service reviews, we note that a particular problem is presented by intangible assets. The Commission seeks comment on whether and how much "goodwill" should be included in the rate base.[26] We first suggest that a clarification of terms would be appropriate. We believe that by "goodwill" the Commission actually means "intangible assets." "Goodwill" can be a subset of intangible assets, but there are others as well. In this case, we believe that "franchise value" and "going concern value" should also be specifically considered. The intangible assets result from accounting transactions to reconcile the cost of a system acquisition with the current tangible value of that system. Typically the tangible assets are valued at current market prices or depreciated replacement costs, and the difference between the purchase price and the tangible asset values are assigned to intangibles.[27]

An extensive discussion of the treatment of intangible assets for cable television systems appears in the record of a 1990 United States Tax Court case.[28] The court found that "goodwill" did not exist for certain cable systems that held monopoly status, defining "goodwill" as "the expectancy that old customers will resort to the old place." The intangible assets of a cable system may instead be assigned either to "going concern" value or "franchise" value. For the cable television business, "going concern" value may be thought of as the cost an operator has sunk to acquire new subscribers (and that a purchaser may therefore forego when he buys an existing system rather than starting a new system). The "franchise" value is the residual resulting from subtracting the tangible asset value and the "going concern" value from the purchase price.

Courts have declared that "goodwill" cannot have a value in a monopoly, and we believe that the "going concern" value is typically only a small part of the intangibles that are booked for many cable systems. At most the "going concern" value would be the marketing and other prematurity costs sunk to acquire the subscriber base, distinct from the ongoing operating costs necessary to retain old subscribers.[29] That leaves the "franchise" value as the largest component of the intangible assets.

---

[26] NPRM Appendix B, paras. 3 and 4.

[27] The intangibles are not the premium paid over <u>original</u> cost, as suggested in NPRM Appendix B, para. 3.

[28] United States Tax Court, Docket No. 268-89 (Filed November 7, 1990). Tele-Communications, Inc. and Subsidiaries v. Commissioner of Internal Revenue. 95 T.C. No. 36.

[29] We believe that the burden should be on cable operators to support the valuation of "going concern" value for specific systems if it is to be included in a the cost-of-service rate base. For the systems reviewed in the cited U.S. Tax Court case, the court found "going concern" value to be about 13 percent of the intangible assets.

To define the "franchise" value, we quote at some length from a paper submitted by Mr. William Shew in support of Tele-Communications, Inc. in the cited tax case:[30]

The value of a franchise stems from the prospect it offers to earn supernormal profits. For this prospect to be credible, the franchise holder must expect that he will be insulated from intensive competition. Otherwise the allure of supernormal returns would attract firms into the market until the rate of return was driven down to the normal level.

The franchisee may be insulated from competition either because the market he serves is naturally unsuited to competitive entry or because the franchising authority protests the franchise holder from competition.... Regardless of how a franchise holder is insulated from competition, the value of a franchise is the (capitalized) value of the supernormal returns expected from the franchised activity -- the income over and above what would provide the investor with a competitive return for the risk involved... Thus, it is the prospect that the authorized activity will yield a supernormal rate of return -- in excess of the investor's cost of capital -- that gives value to a franchise.

The franchise value represents the capitalized value of the monopoly profits expected from the system. To include this component in the rate base and allow a return on it would directly contradict the intent of the Act to eliminate any monopoly component of rates. Rates would continue to reflect a monopoly increment if a return was earned on the franchise value intangible. In addition, allowance of the franchise value intangible would treat systems that have had stable ownership unfairly in relation to systems where ownership has changed, because it is typically only through a sale transaction that a large franchise value may be booked.[31] Allowing the rate base to be stepped up substantially through a system sale would encourage trafficking in systems that presently book relatively low intangible franchise values, a result that we believe would be undesirable for consumers and franchising authorities.

To the extent that current system owners may perceive disallowance of the intangible franchise value as unfair (it does reflect actual capital invested in purchasing the system), we note that the expected rate of return inherent in the purchase price reflected risk assumptions. The future high rates and profits were not and should not be guaranteed.

---

[30] William B. Shew, National Economic Research Associates, Inc. "The value of Three Cable TV Franchises." November 30, 1989; pages 4 and 5.

[31] Although the original operator may have capitalized its sunk costs to acquire the initial franchise, this amount was generally small in relation to the increase in franchise value intangibles that has occurred due to system sales since 1984.

For the same reasons that we believe that intangible franchise value should not be included in the rate base even in a traditional cost-of-service model, we believe it is inappropriate to allow amortization of this intangible item as an expense.

Tangible asset values. The traditional utility cost-of-service approach typically values property, plant, and equipment based on net book depreciated value. As pointed out above, this value can change when a system is sold because a physical appraisal of the assets may be performed to re-value them and potentially "step-up" their net book value. Our proposed benchmarking approach avoids this issue by valuing the physical assets on a replacement cost basis, rather than on net book value. However, the potential step-up in physical asset values could be an issue if the Commission chooses to apply the utility cost-of-service method to individual systems. Similar to the intangible asset concern, the physical asset step-up potential could undesirably encourage system sales. We believe that the Commission's rules, if cost-of-service regulations are adopted, should constrain this potential by rate base disallowances of stepped up values due to a system sale.[32]

Tangible assets for which rates are separately determined, such as converters and remote control units or capitalized installation costs, should not be included in the rate base for basic or other programming services. To do so would provide a "double return" on these assets.

Prudency. The assets included in the rate base should be "used and useful," and the operating expenses that are allowed should be reasonable. Imprudent capital expenditures or unreasonable operating expenses should be excluded. For example, in a system where considerable cost was sunk into a failed design, necessitating re-construction, we do not believe that the cost of the failed construction should be included in the rate base.

smith.rpt(0365)

[32] Increases in physical asset value due to replacement or upgrades should be allowed, if prudent.

REPORT TO THE FEDERAL COMMUNICATIONS COMMISSION IN RESPONSE TO NOTICE OF PROPOSED RULEMAKING TO IMPLEMENT RATE REGULATION SECTIONS OF THE CABLE TELEVISION CONSUMER PROTECTION AND COMPETITION ACT OF 1992

(FCC 92-544; MM Docket 92-266)

APPENDIX A: COST-OF-SERVICE BENCHMARK MODEL

January 27, 1993

Submitted by:

Mr. Jay C. Smith
Public Knowledge, Inc.
Portland, Oregon

Mr. Michael Katz
KFA Services
Edmonds, Washington

Appendix A

COST-OF-SERVICE BENCHMARK MODEL

1. Overview of the Model

We propose a cost-of-service benchmark model to assist franchising authorities and the Federal Communications Commission (Commission) to regulate cable television rates, consistent with the requirements of the Cable Television Consumer Protection Act of 1992 (Act). The model combines certain national normative data on cable television system costs with inputs specific to the local franchise area. National norms would be developed after collection of cost data and a further rulemaking. While the example discussed below indicates specific factors we believe are most likely to prove appropriate for local specific treatment, the Commission could, as a matter of policy, or if the data allows it, include fewer or no local specific factors. The model may be run using actual local cost factors, a combination of local and national norm information, or with national norms alone. The proper balance will depend upon the ability of the Commission to develop reasonable norms for particular cost categories, on policy choices, and on the likelihood that the resulting mode will produce rates that are neither too high nor too low.

The result of the model is a rate ceiling for both basic and expanded basic service tiers. It addresses each of the factors that Congress and the Commission specified for consideration. We believe that the benefits of the proposed model include the following:

- Assures that basic service and expanded basic rates are collectively reasonable, protecting subscribers of any system not subject to effective competition from paying rates higher than those that would be charged if the system were subject to effective competition

- Applies consistent procedures to basic and expanded basic tiers

- Requires only information that is readily obtainable

- Based on a spreadsheet or table that may be distributed to local franchising authorities to ease administrative burdens for both local authorities and the Commission

- Provides appropriate incentives for cost control by applying normative costs

- Reflects the key relevant local factors, including those specified in the Act

- May be used as the method to determine annual price cap changes

Appendix A

The model addresses each of the factors which the Commission wishes to consider and which are specified in the Act as follows:

- **Rates for cable systems that are subject to effective competition.** The model simulates the rates that would be required to sustain a competitor if the competitor enjoyed the same economies of scale and scope as operators facing no effective competition. The competitive rate is simulated by including all reasonable costs of providing the service, but excluding any increment above that required to produce a reasonable return. Cost data from systems facing effective competition could be used as an important sub-sample of the data collected to develop the norms that help drive the model.

- **A reasonable profit, consistent with the goal of protecting subscribers in any cable system not subject to effective competition.** A reasonable return on investment component can be included in the model, sufficient to attract capital to the business.

- **Rates for similarly situated systems taking into account similarities in costs and other relevant factors.** The cost norms used in the model will be based on cost data collected from a broad sample of systems. If there are verifiable differences in normative costs based on system characteristics (number of subscribers, plant miles, market, etc.), the norms could be grouped in categories that allow the benchmark for any particular system to be based on norms for those systems that are similarly situated. The rates produced by the model for any given community will be similar to those produced for communities that are similarly situated.

- **The rates for the system as a whole (other than programming provided on a per channel or per program basis).** The model generates rates for both the low basic and expanded basic tiers, so the reasonableness of the total rate may be assessed. The model also includes revenue from equipment and installations; this revenue is segregated from the revenue requirements for basic services.

- **The history of rates for the system including their relationship to changes in general consumer prices.** The model can be used to evaluate rates as industry costs change. It may be used to calculate an index for price cap changes, and the index may be compared to changes in general consumer prices.

- **The capital and operating costs of the system.** The model calculates rates based on the capital and operating costs. In the model, these costs are derived using national norms for construction costs and local specific factors, such as plant miles, that determine the final system costs.

- **The direct cost of obtaining, transmitting, and providing basic tier programming.** The model can either use national norms or assign programming costs to the appropriate tier based on actual channel line-ups for each specific franchise area. In addition, if costs such as retransmission fees, for example, vary by community, the model can be made sensitive to the variance.

- **Only a reasonable and properly allocable share of joint and common costs.** The model applies reasonable methods to allocate joint and common costs among basic, expanded basic, and pay services.

- **Revenue from advertising and other sources.** Consistent with the requirements of the Act, advertising and other revenues associated with the basic and expanded basic services tiers are included.

- **The reasonable and properly allocable portion of taxes and fees imposed by any state or local authority.** Specific local inputs may be included in the model to assure that such taxes are included.

- **The cost of satisfying franchise requirements to support public, educational, and access (PEG) channels.** The model may include a specific local input for PEG support, or national norms, as appropriate.

2. Key Concepts Incorporated in the Model

The model simulates a cable operation having the same economies of scale and scope that the existing operator has in particular franchise markets. Actual numbers of subscriber counts, plant mileage, and channel offerings are used to help assure that the scale and scope factors fairly represent the actual local conditions. However, to avoid the need for hundreds or thousands of detailed local cost-of-service studies, normative cost data can be used for all or most key cost variables. The use of cost norms helps assure that the costs that are included are reasonable and prudent, and creates an incentive for efficient expenditure.

An overview of a simplified model appears in Exhibit A-1. The variables shown in the exhibit are used to calculate return on capital and operating expense norms. A norm for capital expenditures to maintain the system is also included. The revenue requirement is the amount necessary to cover a return on capital, capital replacement and operating expenses. The revenue requirement, divided by twelve times the number of subscribers (to convert to monthly) yields the cost based rate for any given service tier.

EXHIBIT A-1

OVERVIEW OF SIMPLIFIED COST-OF-SERVICE BENCHMARK MODEL